
RESEARCH AND DEVELOPMENT TAX INCENTIVE CONSULTATION PAPER

AIIA Response

October 2009



EXECUTIVE SUMMARY

The Australian Information Industry Association (AIIA) thanks the Government for this opportunity to comment on the draft proposals for change to the R&D tax concession scheme.

On behalf of the ICT industry AIIA believes that the net impact of the proposed measures is likely to be damaging to our sector's innovation capabilities, particularly in the SME area, and we strongly recommend that these issues be addressed in a redrafting of the proposed policy.

AIIA supports reform of the current R&D tax incentive to remove opportunities for inappropriate claims, tighten compliance and ensure it is more effective in delivering genuine support for those businesses investing in R&D in Australia. Any such support should be targeted to R&D activities that deliver net benefits to the Australian community and economy. The proposal to adopt a refundable 45% tax credit regime for SME's is welcomed by AIIA.

However, the proposed amendments to the scheme display policy, design and definition characteristics which, if implemented, will cause critical diminution in the level and quality of R&D carried out in Australia by SME's and others because it will be difficult or impossible to sustain the level of financial commitment necessary to support effective R&D. This in turn will diminish the level of innovation in Australia which is already behind many of our trading competitors.

Scheme Objectives

The current tax concession scheme for R&D was established in 1985 to encourage companies to "undertake increased levels of eligible R&D" and its stated objectives

include “creating an environment that is conducive to increased commercialisation of new processes and product technologies development by eligible companies.”¹ To 30 June 2008, 6806 companies had registered their intention to claim under the scheme, reporting an R&D spend of \$11.59billion, continuing a trend of previous years with an increase of 6% over the prior year. Apart from the 96-97 and 99-00 years, annual R&D spend has increased annually since 1985. While the Innovation Australia report does not analyse the impact of such growth in spending, it would seem to indicate that the scheme’s original stated objectives (to increase investment in R&D) were in the process of being met, prior to the announcement of the proposed changes. From data supplied in the Report it can be seen that *ICT R&D spend accounted for approx \$2.5billion of the \$11.59billion total.*

The three top sectors by ‘use’ of the concession are:

- Engineering & Technology
- Information computing and communications sciences
- Medical and health sciences.

Proposed Changes to the Scheme

AIIA members’ specific concerns include:

- The move to a dual definition requirement that eligible R&D must be *both* innovative *and* highly technically risky;
- The proposal to limit or remove claims for supporting activities in the R&D process;
- The potentially inequitable treatment of expenditure incurred in development of software;
- The potential discouragement of smart applications using the NBN

¹ Innovation Australia Annual Report 2007-2008

DEFINITIONS

“Involves both innovation *and* high levels of technical risk” is the proposed new approach to define R&D activity that is already SIE, with this added requirement of dual proof. The paper states that absent either of these dual requirements, there is a reduced likelihood “the activity will produce spill-over benefits and be in addition to what would otherwise occur”. There is no market or case evidence provided in the Paper to support this statement; the paper claims in para 54 that subsidising innovation without high risk (or risk without innovation) does no more than reward a company for doing what is “already commercially sensible”. The logical corollary of this is that subsidising activities that display *both* elements rewards companies for doing what is *not* commercially sensible. This makes a mockery out of the public policy debate surrounding the issue. Further, it implies, as noted by KPMG² in their response to this review, that companies make a decision to proceed with an R&D project *solely* as a result of a tax incentive – they do not. The stimulus for R&D activity is the prospect of a successful outcome, both commercially and for the consequential benefit of the rest of the economy. “The objective should be to create an overall environment conducive to...enhanced R&D activity but not to disallow what would otherwise qualify as R&D activity...*merely because the enterprise was committed to that activity regardless of the incentive.*”³ In other words, the company had already committed to activity that was ‘commercially sensible’, to use the Paper’s own words.

Currently, R&D activities only have to display one of the characteristics of innovation or technical risk. Attempts by previous governments to amend this approach were rejected by practitioners and industry for apparent and sound reasons, including:

- Complexity
- Compliance burdens for taxpayers
- Being out of line with definition in the Frascati Manual, one that is still broadly accepted by OECD jurisdictions

² KPMG response to Consultation paper of September 2009. Page 4

³ Ibid; page 4

- Lack of evidence that the quantum of claims had expanded due to the separation of innovation and risk
- Lack of common understanding by government assessors as to what constituted “innovation”

Unless new evidence can be sustained by the Government to defeat these objections today, there seems no supportable policy reason put forward to explain to industry why there is a need to change the definition. AIIA recognises and accepts the Government’s revenue concerns at para 50 – at the current rates and turnover threshold the Budget is exposed to lower value-add claims and thus the revenue will eventually suffer. However, if the current scheme is continuously exposed to ineligible claims and sectoral rorting, AIIA strongly urges the Government to address *compliance, assessor skills and guidelines* so that taxpayers cannot make spurious claims and assessors will not allow them. This is preferable to a complete overhaul of a scheme such that its original objectives risk compromise, R&D may decrease in Australia, economic benefits reduce and sectoral rorts still feature. Further, the latest Annual Report from Innovation Australia notes that compliance is based on risk management, and that year to date, “the majority of [registered] companies represent a low risk in respect of their R&D eligibility”.⁴ If this is the case, and there is a sectoral trend emerging that indicates non-eligible claims being inappropriately allowed, this is all the more reason to address the process of allowing claims, the skills of those assessors managing those claims (especially regarding the characteristics of innovation), and the general guidance available for all stakeholders in the scheme.

In addition, such a change risks taking Australia out of line with OECD norms set out in the Frascati manual which indicates that research and experimental development does not need to be innovative *and* highly technically risky; it merely refers to creative work done on a systematic basis, including basic, applied and experimental research.⁵ If Australia moves towards a more restricted definitional approach, leaving other jurisdictions with less onerous definitions and thus more encouraging environments in which to invest, the outcomes for Australian R&D can readily be predicted; it will move to those more favourable jurisdictions. In this regard AIIA notes the

⁴ Innovation Australia Annual Report; page 31

⁵ Frascati Manual 2002 – OECD website

observation by KPMG that the UK, Canada and Ireland retain a 'sole requirement' approach to definitions of R&D.

Software and its importance to Innovation

Software development is by its nature risky. Due to the advent of the web, cloud, SaaS, web services, IPv6 web 2.0 etc, the process of developing software is now a real-time one, and necessarily non-linear - the days of the two year project and 'hope for the best' at the end are gone. A more experimental approach is being taken with increased use of X-treme programming / agile development methodologies. This means that innovations occur more rapidly and intermingle the various other disciplines in the economy using ICT - for that reason concepts such as splitting core and supporting activities become obsolete (the entire process is a core activity).

Collaboration in software development is crucial - many of the problems facing Australia are too big for government, companies or individuals to handle on their own. The Australian ICT sector is ranked second worst for collaboration amongst large (20%) and small firms (14%). Employees account for the greatest source of innovation. Customer focussed and business partner focussed R&D (38%) rank well ahead of academia (12%) and even in-house R&D departments (14%).⁶ The focus following the UK examples given in the Treasury consultation paper are towards theoretical development of new languages etc - in contrast to the market realities today of having customer driven, component driven architecture.

Innovative software development which is then commercialised and included in all sectors of the economy clearly acts as a productivity enabler across the economy; in this regard it must be treated in the same way as any other R&D activity. Sectors which have already benefited from innovative software development in Australia include:

⁶ KPMG client data

- green technologies - water management, smart electricity grids, intelligent transport systems, demand load management
- mobile / in-the home health service delivery, financial/commerce solutions, education, particularly in an aging population
- supply chain management and logistics
- the built environment

Core and Supporting Activities

As noted by KPMG, the concept of dividing core from supporting activities in the R&D area is not one that is recognised internationally. Provided the activity is necessary for the successful pursuit of the R&D project, it should be eligible under the tax concession. In particular, all components (core and supporting) of R&D activity that is innovative or technically risky will of necessity comprise activities that are eligible for tax concession – in this regard the division between the two concepts is somewhat artificial because the risk, experimentation and innovation arises from the novel or unique manner in which all activities are either undertaken or combined to produce new processes, knowledge or materials. To the extent that supporting activity is essential for the development, then it must have the same ‘contribution’ impact to the overall outcome as does core activity. Treating supporting activity less favourably means that core activity is indirectly impacted less favourably as well.

The Paper notes that claims for supporting activities frequently are higher than those for core activities, and the concern appears to be that this is a threat to the revenue. This indicates that the government is not addressing the possible characteristics of core versus supporting activities, but is more concerned with removing the revenue cost. If the current scheme is clearly open to spurious claims involving supporting R&D activity, again we would recommend the government address the compliance and assessing mechanics of the scheme through better assessing guidelines and better claimant

education, rather than compromising the positive objectives of the scheme through complete overhaul. The options provided in the Paper to address the relativities and 'leakages' of claims between core and supporting activities again point to the fact that compliance and assessing skills must be addressed; leakage in particular is merely an attempt to rot the scheme, and such activities by claimants can be addressed (as they are in the overall taxation system) through strong compliance mechanisms and better skills for assessors.

Impact on the NBN

ICT is fundamental to the development of a vibrant digital technology –as well as providing possible new and innovative ways in which to build the NBN itself, it creates the capacity for the nation to build smart applications on the back of the National Broadband Network development. NBN can provide the infrastructure for a range of health, education, agriculture, science and engineering solutions enabled by ICT that should be developed here as much as possible, and which should receive government support through an appropriate R&D tax incentives system. AIIA is concerned that the current proposals in the Paper send the wrong message to those engaged in the development of these applications now, and that the levels of uncertainty created by conflicting messages through policy dysfunction will discourage innovative activities in the NBN environment.

ABOUT AIIA

The Australian Information Industry Association (AIIA) is Australia's peak technology industry body. AIIA's role is to lead and represent the ICT industry in Australia to maximise the potential of the Australian economy and society. AIIA's membership encompasses all sectors of the ICT sector including hardware, software, services and

telecommunications. It has almost 400 member companies, from individual consultants, small to medium enterprises to the world's leading multinational corporations.

AIIA member companies employ over 100,000 Australians, generate combined annual revenues of more than \$40 billion (approximately 5% of GDP) and export more than \$2 billion in goods and services each year.